Is financial innovation market-driven or bank-driven? The case of private equity in the 1980s

Carolyn Sissoko

Workshop on Critical Macro-finance
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Overview

- Basics: private equity, LBOs
- Claim: the 1980s LBO boom was bank-driven
  - Evidence from call reports
- Historical narrative: Why the 1980s?
  - Rebuttal of the standard narrative
- Implications:
  - PE started as a bank bailout
  - PE now part of the TBTF ecosystem
- Conclusion: PE is subsidized just like TBTFs

Private equity: some basics

"Private equity": a 1990s rebranding of leveraged buyout firms

Why rebranding?

Leveraged buyouts (LBOs) were controversial

What is an LBO?

The purchase of a firm that trades on the stock market, 'taking it private'

... but not paying cash for the shares

Instead the buyer/owner puts up about 10% of the price

... and borrows 90%, but buyer/owner does not owe the debt

... instead **the target/purchased firm owes the debt**

Types: hostile takeover vs management buyout, etc

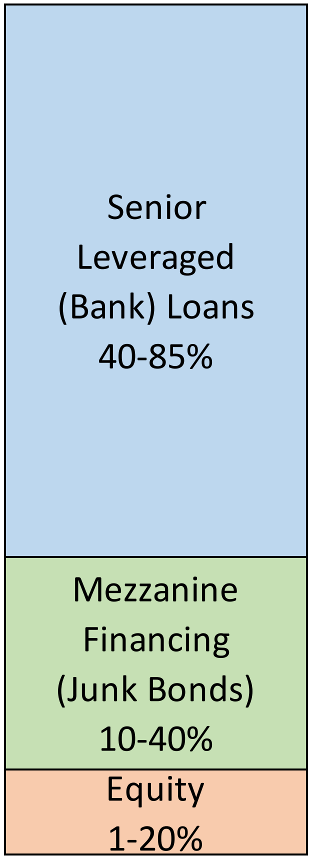
NB: buyer/owner may finance the equity stake too

Should this even be legal? Very controversial initially, but now accepted practice

1980s LBO debate

- Proponents
  - Trust the market (Ginsburg 1986)
  - Jensen (1986): debt limits the ability of managers to make use of corporate assets in their own interests
- Opponents
  - Driven by conflicts of interest (Osterberg 1989)
  - Loading corporations up with debt
- Comment
  - Beneficiaries of the debt do not owe the debt!
    → transfer from corporate stakeholders to shareholders,
    Biggest benefits to *new* shareholders/private equity
  - Driven not by market-based debt (junk bonds),
    but by bank debt (syndicated loans)

- Typical LBO funding structure (Borio 1990b: 7)



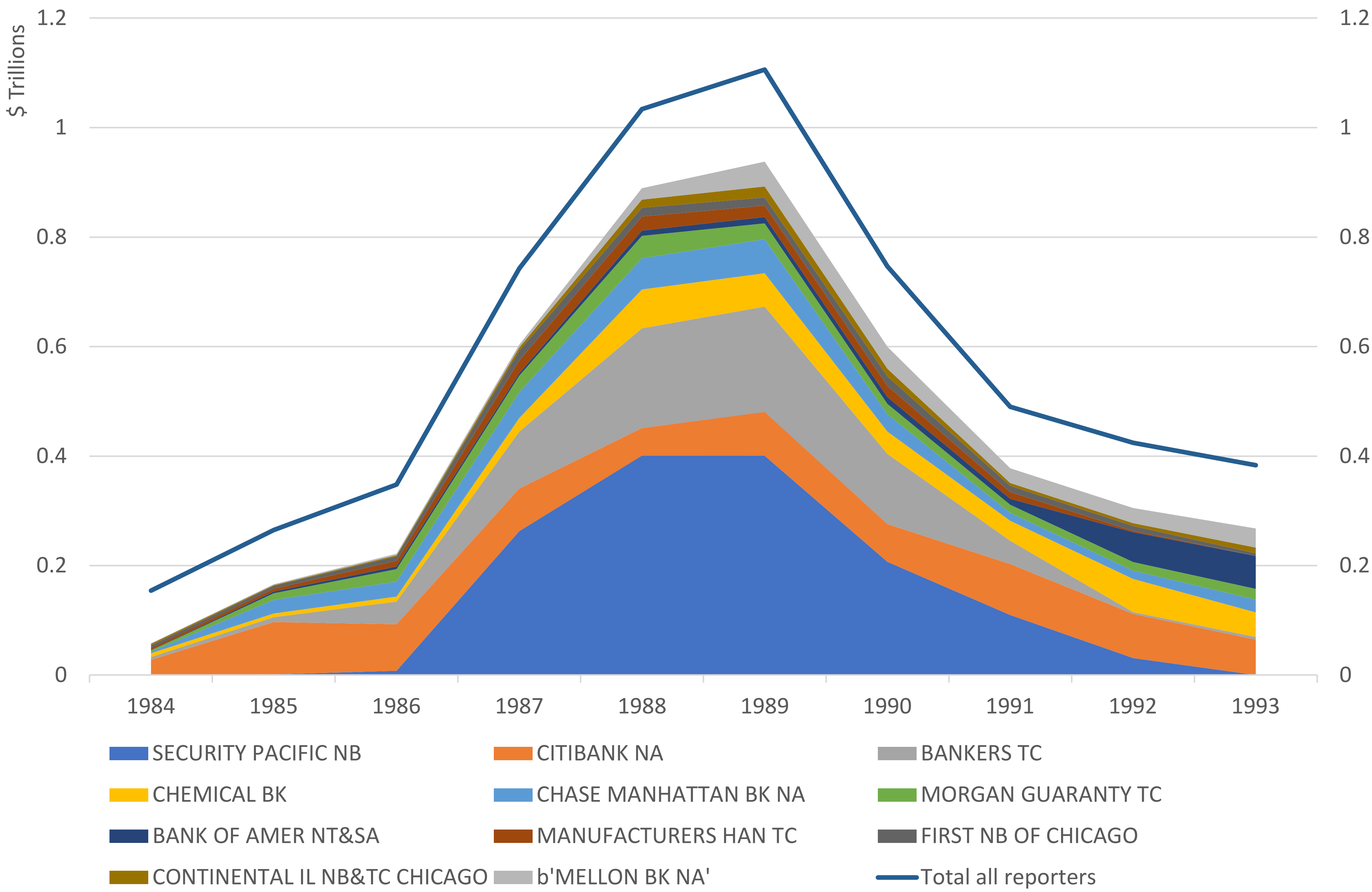
Claim:
the LBO boom was bank-driven

- Contemporary reports (Thackray 1986; Seidman 1989; Borio 1990b; Osterberg 1993)
- Very rapid growth of LBOs
  - 1980: virtually none
  - 1986: $30 billion in deals
    (1986: IPO of the year Microsoft - $61 million)
  - 1989: $50 billion in deals

Claim: the LBO boom was bank-driven

- Originate and distribute (syndicated) lending
  - Fee income in addition to interest income
- Big banks hold only 10-15% of the loans
  - 1988 top 10 banks: 13% of all business loans held are LBO loans
  - 1988 Bankers' Trust: 25% of business loans held are LBO loans
- Call report data
  - Quarterly, every commercial bank must file
  - RFCD3431: Loans originated and distributed
    - Includes LBO loans, but others too

Chart 2: Loans originated and distributed (sales/participations)



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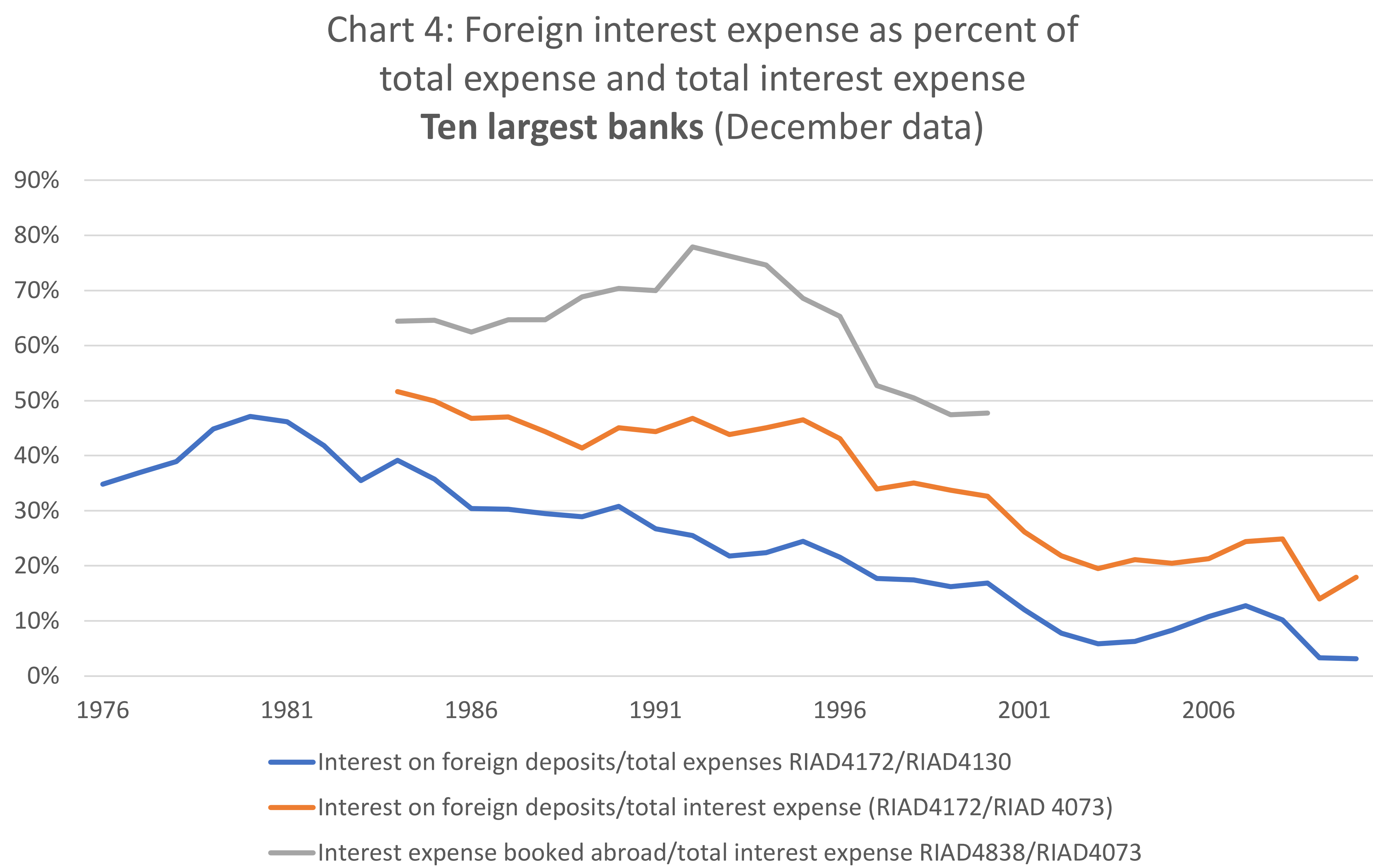
  - 1991-1992: reporting on Highly Leveraged Transactions
    - Stopped because it was affecting the market
- **Lending OKed by regulators because good for banks: manageable risks, high yields, high fees**

Historical narrative: Why did the regulators want high big bank earnings?

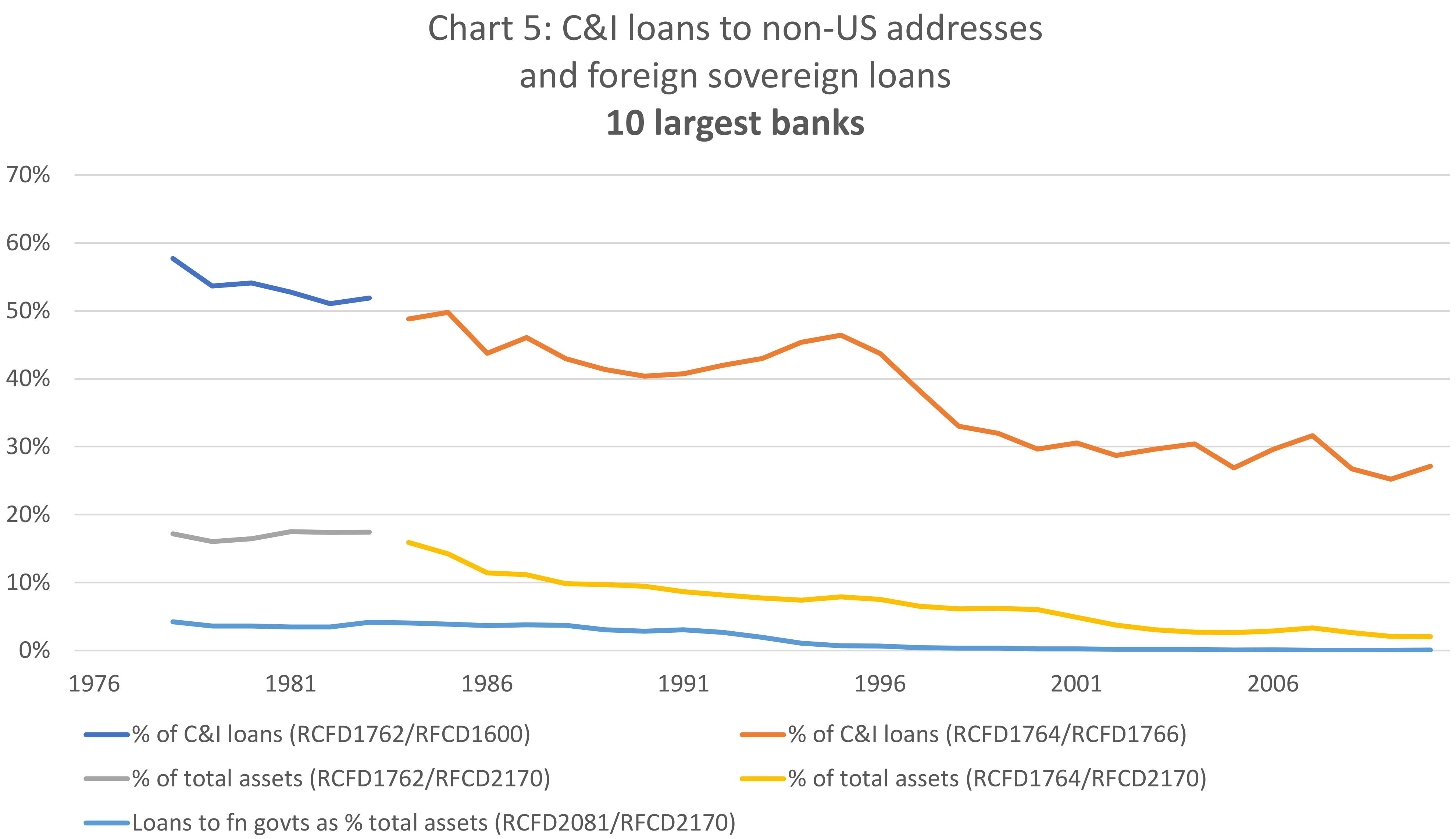
1974: start of US ‘too big to fail’ policy for internationally active banks

- TBTFs get petro-dollar funding to invest
- Create syndicated loan market
- Massive growth of lending to low income countries

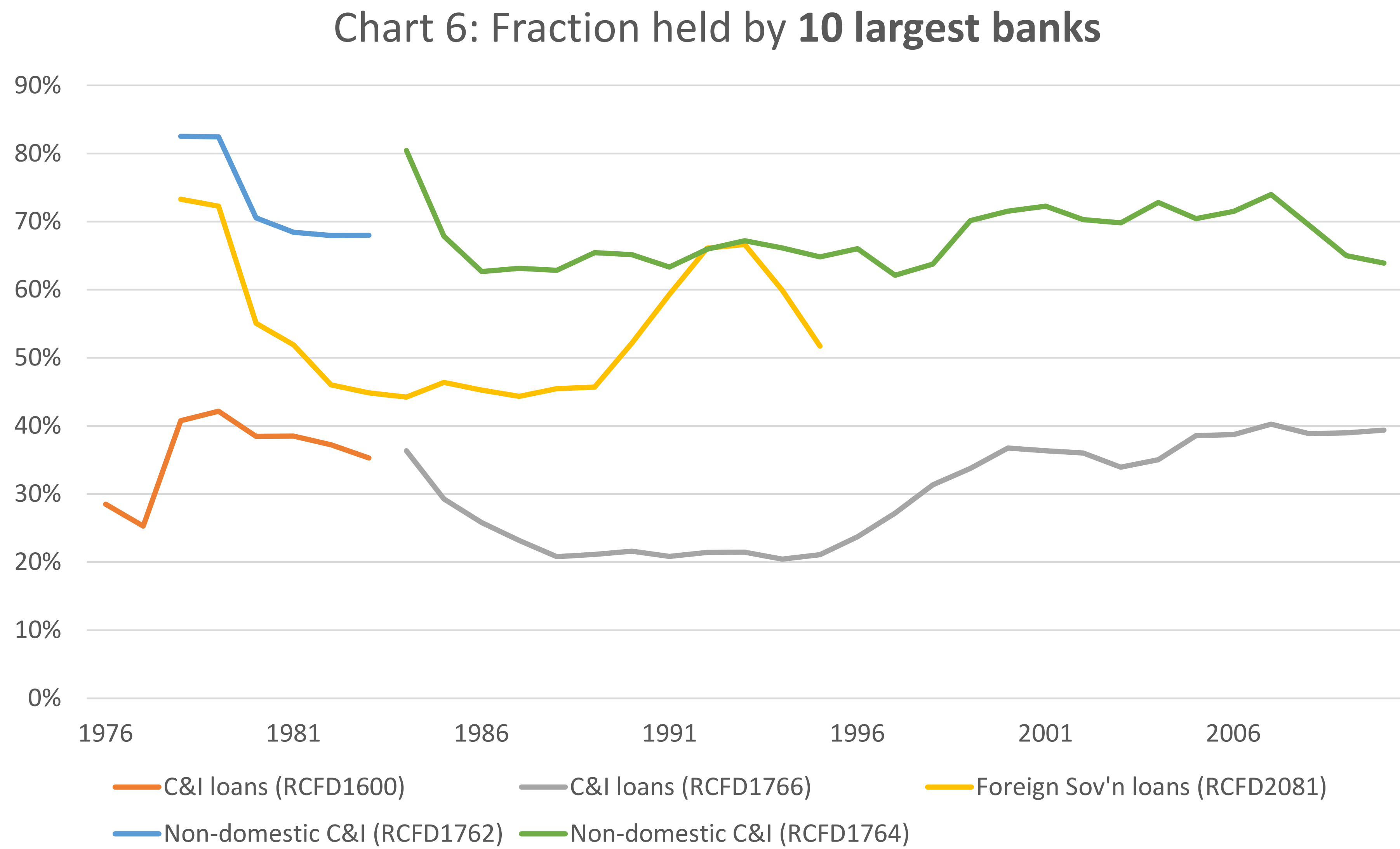
TBTFs dependent on foreign funding



TBTFs: half of business loans are foreign in 1970s



TBTFs: in 1979 hold 70-80% of foreign assets in US banking system



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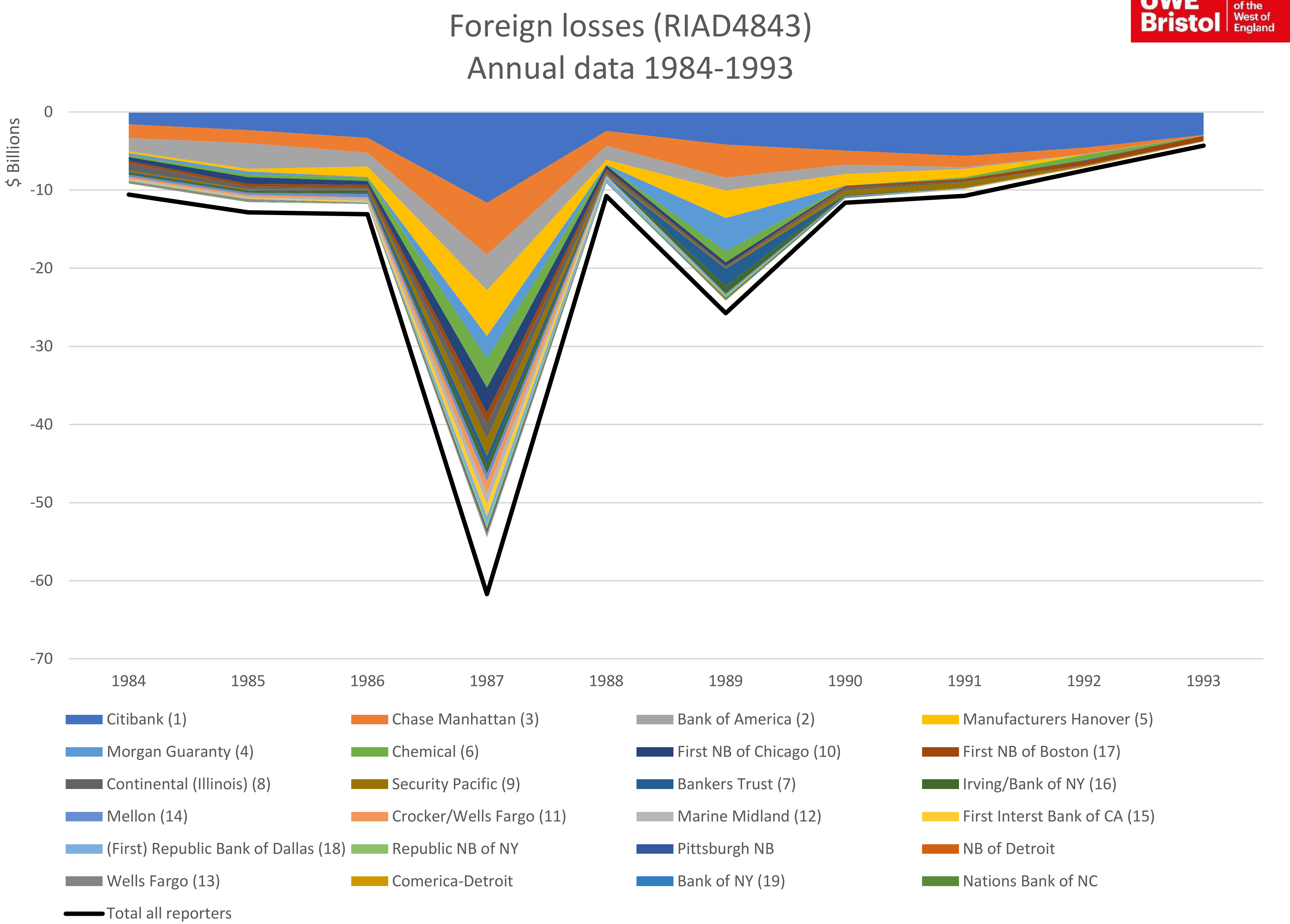
1982: LDC debt crisis

1984: LBO boom starts as syndicated loans get reconfigured for corporate borrowers

→ LBO boom makes it possible for TBTFs to ‘grow out of’ LDC debt overhang



Foreign losses (RIAD4843)
Annual data 1984-1993
$ Billions
0
-10
-20
-30
-40
-50
-60
-70
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
Citibank (1)
Chase Manhattan (3)
Bank of America (2)
Manufacturers Hanover (5)
Morgan Guaranty (4)
Chemical (6)
First NB of Chicago (10)
First NB of Boston (17)
Continental (Illinois) (8)
Security Pacific (9)
Bankers Trust (7)
Irving/Bank of NY (16)
Mellon (14)
Crocker/Wells Fargo (11)
Marine Midland (12)
First Interst Bank of CA (15)
(First) Republic Bank of Dallas (18)
Republic NB of NY
Pittsburgh NB
NB of Detroit
Wells Fargo (13)
Comerica-Detroit
Bank of NY (19)
Nations Bank of NC
Total all reporters

Historical narrative: Rebutting the standard narrative

Standard narrative: Banks 'forced' by markets to innovate

- Loan competition: junk bonds, commercial paper, international banks
- Deposit competition: money market funds

Narrative rings true for small banks that faced a very difficult environment

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But these NBFIs support large banks

- MMFs: a source of funding
- Commercial paper: a source of fees
- Junk bonds: supported syndicated lending to buyouts
- International markets: a source of funding – and potential profits

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Rebuttal: ‘market-based’ NBFIs are part of the Too Big to Fail eco-system that entrenches the power of large banks

- Note however: large banks did grow slowly in the 1980s

– due to the need to absorb the loss overhang from the LDC crisis

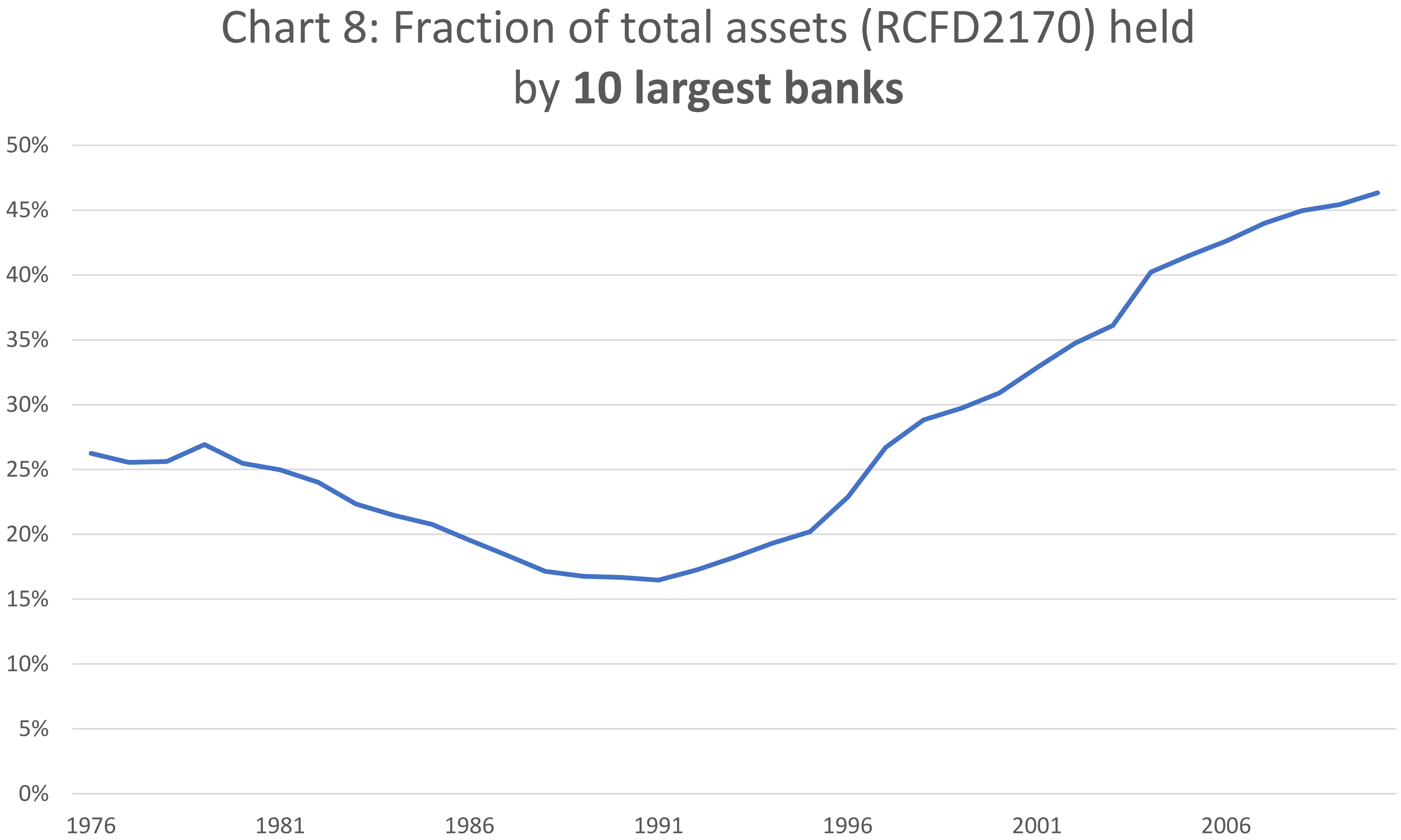
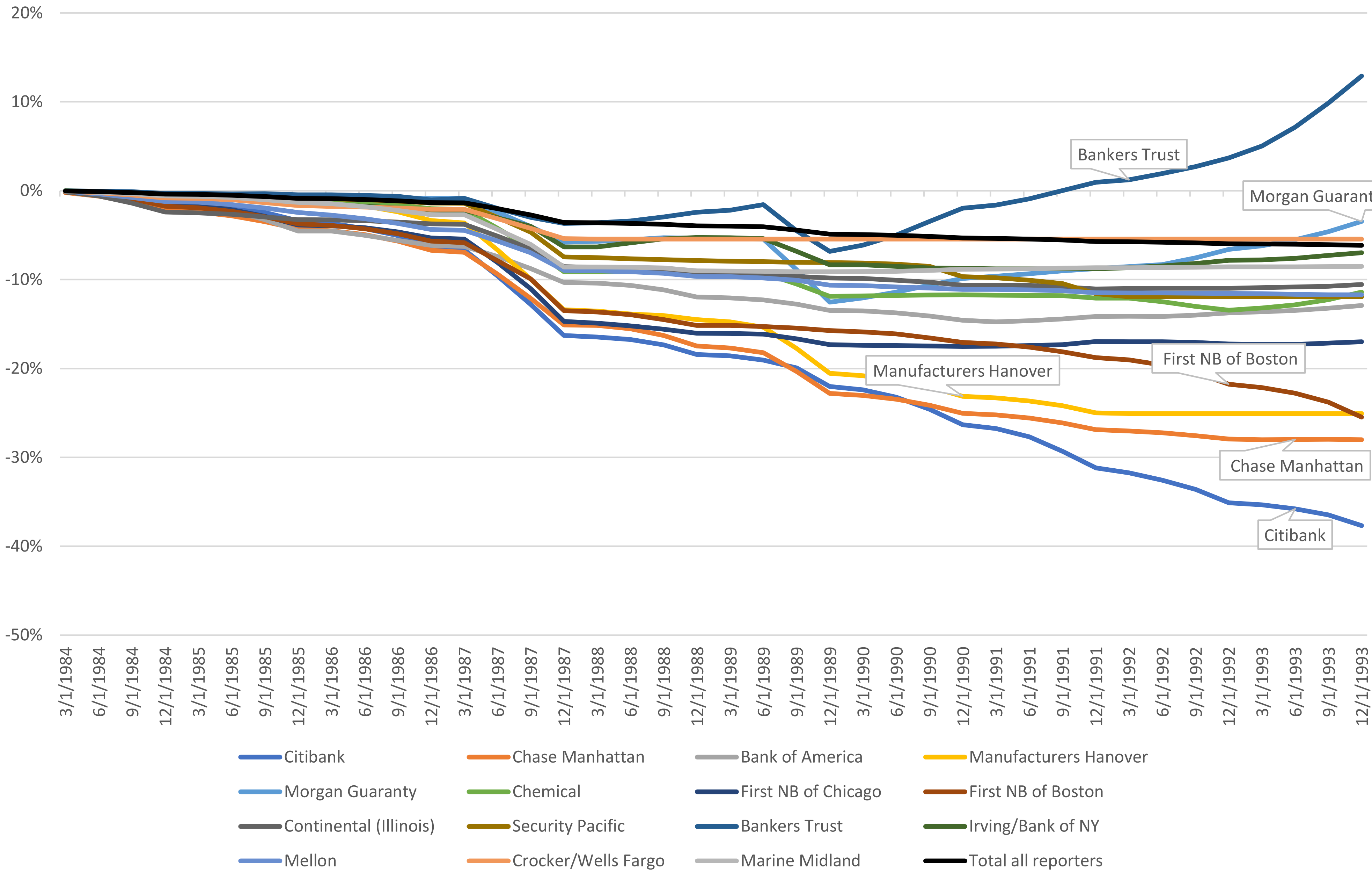


Chart 8: Fraction of total assets (RCFD2170) held
by **10 largest banks**
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
1976
1981
1986
1991
1996
2001
2006

Foreign Losses as percent of 31 March 1984 Assets
Cumulative 1984 to 1993



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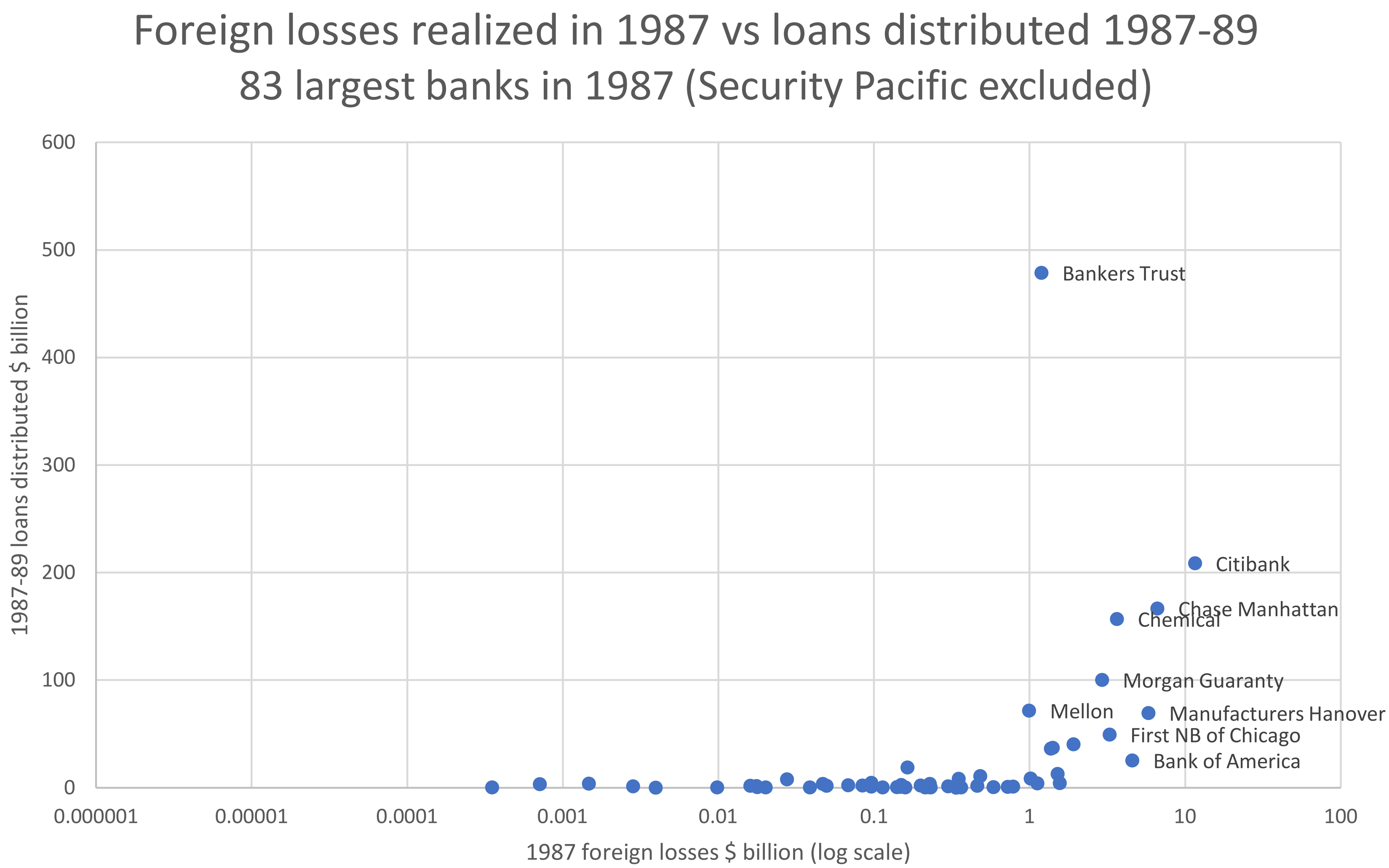

Implications:

- Model (Schumpeter 1939, Smith 1776)
  - Related to: horizontalists (Moore 1988), circuitists (Graziani 1989), (Minsky 1980: "only that which is financed can occur")
  - Bank-based credit flows both
    - Underlie creative destruction and growth and
    - May drive distortionary dynamics
      - Asset-price bubbles
      - Keeping zombie firms alive
- Banks as issuers of money shape the economy, determine which firms thrive and which fail
- When a phenomenon is bank-driven, it is prone to be a distortion that causes mispricing

Implications: New narrative

- TBTF banks with *de facto* US government guarantee
  - Needed to 'grow' out of LDC crisis debt
  - Private equity developed to meet the needs of the zombie banks
    - Financed leveraging of US corporate sector to pay banks fees and 2% yield markup

  → private equity *de facto* funded by TBTF policies
- PE then became an asset class that the banks were so exposed to that it couldn't be allowed to fail
    - 1992 end of call reporting on highly leveraged transactions
    - Fed's post-2008 'low for long' policy
    - Fed's 2020 support of CLOs and high-yield ETFs
    - 2023 Bailout of Silicon Valley Bank's PE depositors

Implications: New Narrative

- TBTF banks created private equity as a means of making high yield loans and fee income that would allow them to ‘grow’ out of LDC lending losses.
  - While entrenching their TBTF status
- Result: the billionaire factory (Phalippou 2020)
  - Increasing share of GNI to financial sector
  - ? Decline in US SME funding and in US productivity

Conclusion

- Leveraged buyouts boomed as a means of bailing out zombie TBTF banks
  - This bailout explains why large US companies became highly indebted
  - Bank-driven: Nothing ‘market’ about this phenomenon
  - Private equity developed as enablers of this bank bailout
  - Then bank exposure to private equity made it too big to fail too (cf Kettering 2008)
- Private equity is just as subsidized as TBTF banks – and part of the TBTF ecosystem. Need to treat it as such.
  - “Private” financiers expect government subsidized returns
  - When they ask: “What do you need to do to bring us in?” Actual question is: “How are you going to make this another government subsidized return?”